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UnHAMPered:FDR's Superb fix for our housing crisis

by Rep. Brad Miller

The Obama plan, by contrast, has misunderstood the calculus faced by homeowners facing foreclosure. An underwater homeowner has little incentive to save their home from foreclosure, even if the monthly payment is reduced. Mortgage modifications that reduce the principal are far more successful than modifications that reduce the interest rate. A homeowner with equity to protect will find a way to pay the mortgage. In contrast, for underwater homeowners a mortgage payment is just expensive rent.

A mortgage modification that reduces the principal, however, results in an immediate accounting loss for the mortgage holder. Mortgage holders often will "extend and pretend." They negotiate payment schedules and lower interest rates. But 70 percent of voluntary modifications add missed payments and penalties to the loan balance, actually resulting in higher principal.

Also, roughly half of troubled mortgages now have "second liens," a second mortgage or a home equity line of credit. Second liens are secured by the value of the home in excess of the first mortgage. Home values in many markets have declined by well more than the amount of most second liens. A reduction of principal on the first mortgage would often just be a gift to the second lien holder, still leaving the homeowner with negative equity in their home.

What's more, banks and other investors now own pathologically complicated securities, the "toxic assets" on which the financial crisis was blamed. These securities pool together mortgages, car loans, credit card debt, student loans and whatever else, usually in combination with various derivatives. A decision to modify a mortgage may be in the best interest of some investors, but a decision to foreclose would be more advantageous to others.

The "servicers" who decide to foreclose or modify mortgages have their own interests. The four biggest banks—Bank of America, J.P.Morgan Chase, Citigroup and Wells Fargo—control two-thirds of all servicing. The same four banks hold $442 billion in second liens. So the failure of the industry to modify mortgages voluntarily, even with the inducements of HAMP, should not be terribly surprising.

That's why there's a need for a much stronger government role in this crisis. Some in the financial industry may be more willing to sell mortgages to the government at a discounted price than they are to modify mortgages themselves. Servicers fear that if they offer affordable mortgage modifications to struggling homeowners, many more homeowners will stop paying and wait for an offer. Selling a mortgage to the government may avoid that problem because the government would modify the mortgage, not the servicer.

But for many of the same reasons that the financial industry has not modified mortgages voluntarily, others in industry would not likely sell many mortgages voluntarily either, at least not at a realistic discount. So how can a new HOLC work if mortgage holders will not voluntarily sell mortgages?

The new HOLC could buy mortgages by eminent domain. Eminent domain powers are most commonly used to purchase land for highways or public buildings, but also to renew "blighted" neighborhoods or clean up contaminated land. And existing law allows the use of eminent domain to purchase property interests other than the outright ownership of land.

Some uses of eminent domain have resulted in public wariness and resentment. The Supreme Court's 2005 decision in Kelo v. City of New London allowed the condemnation of family homes for an "economic development" project from which private developers profited. A mortgage in a securitized pool is no one's castle.

The toxic assets backed by mortgages are impossible to value. The concern that taxpayers would get fleeced buying toxic assets from the financial industry was well justified. Whole mortgages are not hard to value at all. There are frequent, well-publicized auctions of mortgages with a sufficient number of informed, sophisticated buyers. The auctions are an almost perfect pricing mechanism. The problem for the financial industry is not the difficulty of valuing troubled mortgages; the problem is that many mortgages are not worth much. There are obviously many considerations in the price, but distressed mortgages generally sell for about 30 to 50 cents on the dollar at auction. And any honest valuation of many second liens would be pennies on the dollar.

If the government could purchase, either by voluntary sale or by eminent domain, distressed mortgages for 30 to 50 cents on the dollar, there would be ample room to reduce the principal to make the mortgage affordable. In other cases, the government could buy the home in exchange for cancelling the mortgage and enter into a long-term lease with the former homeowner.

Like the original, a revived HOLC could pick and choose the mortgages it buys. The new HOLC should only buy mortgages on owner-occupied homes, and should refuse to buy reasonable mortgages that homeowners can afford. So no homeowner should expect that the HOLC will buy their mortgage if the homeowner stops paying.

The Obama administration can establish a new HOLC without any additional action by Congress. The Troubled Assets Relief Program (TARP) legislation already gives the Treasury Department the power to acquire financial assets, specifically mortgages, and Treasury could fund the program with the $75 billion of the TARP appropriation allocated for HAMP.

That should be plenty to buy enough discounted mortgages to put a dent in the foreclosure problem. Most important, the prospect of eminent domain acquisitions of mortgages at a deep discount will motivate servicers to reduce principal voluntarily. Every government foreclosure mitigation effort so far, including HAMP, has depended exclusively on carrots for the industry, usually designed by the industry itself. The industry's lobbying efforts have successfully denied any stick to go with the carrots, notably the judicial modification of mortgages in bankruptcy ("cramdown"). The acquisition of mortgages by eminent domain will provide foreclosure mitigation efforts with a badly-needed stick.

In normal times, HAMP would better suit our preferences for limited government than HOLC. But the HAMP experiment has failed—and the foreclosure crisis is more dangerous now than it was a year ago. Fortunately, we have a proven method for solving it. We should use it.